WELLS FARGO

June 30, 2005

Office of the Comptroller of the Currency
250 E Street, SW
Public Information Room, Mailstop 1-5
Washington, DC 20219
Attention: Docket No. 05-08
Via E-mail: regs.comments@ooc.treas.gov

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
Washington, DC 20551
Attention: Docket No. OP-1227
Via E-mail:
regs.comments@federalreserve.gov

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Comments
Via E-mail: comments@fdic.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: No.2005-14
Via E-mail: Regs.comments@ots.treas.gov

RE: Comments on the Interagency Proposal on the Classification of Commercial Credit Exposures

Dear Sirs and Madams:

We appreciate the opportunity to comment on the interagency proposal to revise the classification system for commercial credit exposures. And we support the concept of replacing the current commercial loan classification system with a two-dimensional framework.

The concept of classifying commercial credit exposures should be consistent with the dual rating systems adopted by those banks subject to the advanced IRB approach of the Basel II capital requirements. We believe the regulatory classifications should be derived from an expected loss (EL) framework for all banks.

As a major asset-based lender, we have long supported the recognition of Asset Based Lending into the regulatory classification system to better reflect the risk in that segment of our commercial lending business.

However, we believe that implementation of the proposal is premature and that we would not be able to implement the proposal as it stands. We believe both the industry and the agencies are better served to keep focused on implementation of the advanced IRB Basel II compliant systems and not introduce an additional burden at this time. In addition, we are concerned that several of the concepts represented in the proposal warrant further study and consideration by the regulatory agencies. Our concerns are summarized into three broad categories, which are explained in more detail under the comments to the specific issues you have requested:

- The concepts used to achieve a "one size fits all" framework in the proposal do not seem consistent with similar concepts imbedded in Basel II, GAAP, or other regulatory disclosures and guidelines for handling problem loans.
- The definition of default used in the proposal is not entirely consistent as that contained in the Basel II framework.
- The new terminology for borrower ratings should be quantified to probability of default score ranges. The loss severity definitions are not clear and appear flawed in their application, creating confusion and uncertainty.
- The concepts proposed to address Asset Based lending and DIP financing seem arbitrarily prescriptive and cannot be implemented as described.

Assuming that a regulatory commercial classification system is necessary to allow benchmarking of credit risk consistently across the industry, it appears the concepts and terminology in this proposal define a more modern classification system for use in smaller banks with a single rating system. For banks using a Basel II compliant dual rating system, much of the terminology and concepts may be unnecessary and potentially add further confusion. As the evolution of a dual rating system progresses it seems that the system should automatically allow the agencies to derive the commercial classification segmentations to achieve their objectives.

Wells Fargo welcomes the opportunity to participate in ongoing analysis of this proposed change with the agencies. Comments to the specific issues you have requested are contained on the following pages.

Sincerely,

David J. Munio,
Executive Vice President and Chief Credit Officer
Wells Fargo & Company
420 Montgomery St.
San Francisco, CA 94104

Comments to the specific issues you have requested are as follows:

1. *The agencies intend to implement this framework for all sizes of institutions. Could your institution implement the approach?*

   No.

2. *If not, please provide the reasons.*

   <u>One Size Fits All Framework</u>
   The "one size fits all" approach as it is proposed is inconsistent with Basel II, GAAP accounting or other regulatory disclosures and guidelines. Without further clarification or a change in approach, our institution could not implement this proposal as it stands.

   If the agencies desire a "one size fits all" approach to the new classification system, consideration should be given to an "expected loss" matrix, which would be applicable to a traditional one-dimensional or a dual risk rating system for the Basel II advanced IRB approach. An expected loss (EL) framework, which we have in place today, acknowledges the lower loss severity of cash, marketable securities, and asset based lending collateral and could easily be used to derive a regulatory criticized/classified framework. The "remote risk of loss" benefit would be reflected in the higher derived EL. The two components used to arrive at EL will be examined and reviewed routinely under Basel II for accuracy and consistency across the banking system.

   The rating of facilities only at "default" is not consistent with the requirements of Basel II, which requires facility ratings for all borrowers. It should be clear that this requirement applies only to banks not using Basel II advanced IRB.

   <u>Terminology and Concepts (**pages 15683 and 15686**)</u>
   The new terminology of "marginal" and "weak", as well as "default", borrower ratings should be correlated to Basel II probability of default score ranges. Otherwise banks and regulators could significantly differ in their interpretations, more so than with the existing criticized/classified definitions which are solely defined by expert judgment.

   The facililty ratings are a good start, but are not sufficiently granular. At a minimum, we would suggest the following:

Remote	= 0 - 5%
Low	= 5 – 10%
Moderate	= 10 – 30%
High	= 30 - 50%

   The "remote risk of loss" severity estimate of "0%" removes any potential benefit to us, based on our current estimates of loss given default for Basel II purposes. Of course the Basel II loss given default ratios are only estimates and they could be revised when actual data becomes available over the next several years. And we believe Basel II requires that loans in default or in liquidation have a minimum loss severity greater than "0%". A range of loss severity estimates makes sense in the context of this proposal.

Furthermore, Example 3 in the proposal commingles collateral such as livestock, crops, and farmland not under the bank's control with cash, marketable securities, and asset-based lending under strict control of the bank as "marketable collateral". Our estimates of LGD using our current collateral rating system could not be logically mapped under this proposal.

The percentages assigned to the low, moderate and high loss severity categories are not explained and it is not clear how the moderate and high loss severity categories would be used by the agencies, or why these segmentations are even necessary or important, given the move toward segmentation of portfolios by EL.

<u>Asset Based Lending and DIP Financing (**page 15685**)</u>
We have long supported the recognition of asset-based lending into the regulatory classification system. We also recognize the difficulty of writing a prescription for segmenting the risk differently from other secured commercial lending. We believe the concepts proposed to address ABL and DIP facilities could not be implemented.

Consistent with our earlier comments on the proposal, we believe using EL to represent regulatory classifications of commercial credit would automatically incorporate the strengths inherent in collateral and controls associated with ABL and DIP facilities.

Of the three concepts introduced in the proposal, we agree with the "control" assessment.

We strongly believe the "convertibility" concept should not be tied to specified timeframes. In the most effective workout strategies, time to liquidate collateral can vary widely, because the focus is to maximize recovery and therefore produce a low or remote loss severity. The timeframe should not matter if the lender has dominion over cash and control over the assets in liquidation.

We also have concerns with the "coverage" concept and believe the terms "valued" and "over collateralized" need clarification. For example accounts receivable agings and inventory records are typically updated at least monthly. Collateral audits or appraisals are completed less frequently and generally not within the timeframes specified.

3. *What types of implementation expenses would financial institutions likely incur? The agencies welcome financial data supporting the estimated cost of implementing the framework.*

We are incurring significant overhead related to implementing the Basel II advanced IRB compliant ratings and constructing associated databases and credit MIS. The ability to identify classified commercial credit exposures under this proposal would be another element of this process, which would be very difficult if not impossible to incorporate into our reporting process at this time. Implementation costs would be mitigated if the proposal could be better reconciled with the evolving Basel II framework and existing regulatory and accounting rules for loan loss reserves and problem asset disclosures.

4. *Which provisions of this proposal, if any, are likely to generate significant training and systems programming costs?*

   Compared to the overall compliance burden associated with Basel II, the costs associated with implementing this proposal would not be significant. In fact, the dual rating system we have implemented for Basel II is in conflict with the traditional classification system. Our derived internal ratings are meant to be estimates of EL, but no longer translate into the regulatory classifications at the lower end of the rating scale. This currently necessitates significant additional work to translate the new ratings back to the old classification system for external reporting purposes. This additional step could be removed if the new classification system were adopted using an EL approach.

   The primary focus of training for lenders is on our internal rating system, especially the borrower rating. This training is ongoing. The identification of classifications for the agencies is the focus of a much smaller group of credit risk management specialists within the company. Some programming costs and policy updates will be necessary to associate our ratings to new regulatory terminology.

   Use of split facility ratings **(page 15686)** is optional, if we choose to disregard the "remote risk of loss" category. However, the use of split ratings and the "remote risk of loss" category would be essential to the proper estimation of loss severity in several of our lines of business. The proposal would require a use of split CQRs that goes beyond our current usage and therefore could be a programming costs issue or may not be adaptable to our system.

   The use of an alternative rating approach (**page 15686**) for borrowers with aggregate exposures below a specified threshold is a widely used concept in our small business and small commercial borrower portfolios. We strongly support the continued use of that alternative approach as referenced in the proposal.

5. *Are the examples clear and the resultant ratings reasonable?*

   Examples 1 and 2 are clear and reasonable (**pages 15686 through 15687**).

   Examples 3, 4, and 5 raise several questions (**page 15687**), including:

   Example 3 seems to contradict the statement on **page 15685** that loss severity estimates for defaulted borrowers should be conservative and seems inconsistent with treatment applied during regulatory examinations and other external disclosure requirements of problem assets for regulatory (Call Reports) and financial accounting purposes (GAAP).

   Example 4 seems clear and reasonable, except for the following observations. First, there seems to be an assumption that excess cash flow from the performing real estate loan could be used to service the requirements of the non-performing real estate loan. The example should clarify that this would apply if transactions were structured to permit such treatment. Second, past experience with regulatory examiners would indicate that a non-accruing real estate loan with 25% loss severity or deficiency in collateral value would trigger a loss recognition or charge-off. If that were not the case, the alternative would be to establish a FAS 114 impairment reserve of $25, which should be mentioned.

Example 5 seems to be inconsistent with FAS 114 accounting requirements for impaired loans. We agree with the conclusion, but not the approach. The example states that a 10% loss severity is assigned after management recognizes a charge-off based on estimated net realizable value. This estimate is described as equal to its impairment estimate for a pool of similar facilities and borrowers. Our understanding of FAS 114 accounting is that impairment (loss severity) be measured based on an analysis of this specific loan and its collateral or cash flow. The FAS 5 pool accounting concept specified in this example would not be compliant, as we understand GAAP.

Examples 6 and 7 are clear and reasonable (**pages 15687 and 15688**), except for the references to collateral comprising "Accounts receivable from companies with investment grade external ratings". A better representation might be as "good quality" or "eligible" collateral for illustrative purposes. An ABL lender who monitors collateral closely should be able to estimate, based on the paying histories of the customers, whether or not accounts receivables are collectible and therefore eligible collateral for an asset based lending facility irrespective of their investment grade.

6. *Would additional parts of the framework benefit from illustrative examples?*

   Not at this time.

7. *Is the proposed treatment of guarantors reasonable?*

   We agree that a full, unconditional guarantee should be a substitute for the borrower rating. But, in addition, a significant guarantee (for example 25% or greater) should be allowed some influence on the PD or borrower rating.

Other information submitted for consideration, including the optimal implementation date for the proposed changes.

- Given the array of concepts needing further study and evaluation, in our opinion the regulatory agencies should not rush to implement this proposal.
- The regulatory agencies should consider modifying other existing disclosure requirements for non-performing assets to consistently recognize the "remote risk of loss" component. This would allow a better analysis of ratios such as non-performing relative to loan loss reserves in published financial statements.